Principles for Responsible Investment

THE INTEGRATION OF ENVIRONMENTAL, SOCIAL AND GOVERNANCE ISSUES IN MERGERS AND ACQUISITIONS TRANSACTIONS

TRADE BUYERS SURVEY RESULTS

DECEMBER 2012
PREPARED BY PwC WITH SUPPORT FROM PRI

UNEP Finance Initiative
Innovative financing for sustainability
United Nations Global Compact

ABOUT THE AUTHORS

PwC

PwC is a network of firms in 158 countries with close to 169,000 people who are committed to delivering quality in assurance, tax and advisory services. PwC has a market leading Sustainability and Climate Change (S&CC) team and for the past two years has won UK Consultancy of the Year at the Business Green Leaders Awards. This year PwC also won Corporate Livewire's Global Sustainability Private Equity Advisor of the Year. With a global network of 700 full time sustainability professionals and a team of more than 100 specialists in the UK, we are a leading advisor on sustainability, climate change and green growth. Our team works with clients in both the public and private sectors internationally, providing them with policy, strategy, management, reporting and assurance services.

PRI

The Principles for Responsible Investment were launched by the UN Secretary-General at the New York Stock Exchange in April 2006. The Preamble to the Principles states:

'As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society.'

The PRI's Mission Statement – agreed by the Advisory Council in March 2012 is:

We believe that a sustainable global financial system that is efficient in economic terms is a necessity for long-term value creation, rewards long-term responsible investment and benefits the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration for their implementation; fostering good governance, integrity and accountability; and addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

THE SIX PRINCIPLES THEMSELVES ARE:

1. **We will incorporate ESG issues into investment analysis and decision-making processes.**
2. **We will be active owners and incorporate ESG issues into our ownership policies and practices.**
3. **We will seek appropriate disclosure on ESG issues by the entities in which we invest.**
4. **We will promote acceptance and implementation of the Principles within the investment industry.**
5. **We will work together to enhance our effectiveness in implementing the Principles.**
6. **We will each report on our activities and progress towards implementing the Principles.**

This report was prepared with the help of the PRIs PE working group.

**We would like to thank Hermes GPE and Permira whose generous support made this report possible.
We would also like to thank all the companies that participated in the survey.**

CONTENTS

GLOSSARY OF ABBREVIATIONS & TERMS

BRIC	Brazil, Russia, India and China
CAPEX	Capital expenditure
CSR	Corporate social responsibility
ESG	Environmental, social and governance
GP	General Partner
HSE	Health, safety and environment
IPO	Initial public offering
KPI	Key performance indicators
LP	Limited Partner
M&A	Mergers and acquisitions
OPEX	Operational expenditure
PE	Private equity
PRI	Principles for Responsible Investment
TRADE BUYERS	A strategic buyer that already owns a business and purchases or acquires additional businesses
SPA	Sale and purchase agreement
VDD	Vendor due diligence
WBCSD	World Business Council for Sustainable Development

FOREWORD FROM THE PRI INITIATIVE

The past five years have seen a remarkable increase in the number of private equity (PE) signatories joining the PRI. Currently there are more than 150 PE signatories, growing from just two in 2008. In addition, recent years have seen a number of PE associations integrating environmental, social and governance (ESG) considerations into their activities and guidelines and an increasing number of limited partners (LP) and general partners (GP) systematically including analysis of ESG risks and opportunities in their respective due diligence processes.

Historically, many GPs have included environmental and social impact assessments in the due diligence and management of their investments. Further, the benefits of good corporate governance are widely recognised. However, a change is taking place within the industry. There is a growing realisation of the contribution that ESG factors can make to value creation as well as to risk management. This trend does not, of course, exist in a vacuum. A number of fundamental drivers are creating a tailwind for more focused attention to ESG.

After a period of high multiple growth and low costs of debt, which characterised the period 2003-2007, investment returns are now more closely linked to operational improvements in portfolio companies. However, this cannot be delivered by focusing on financial factors alone. There is a growing amount of evidence to highlight how ESG factors can manifest as investment risks and opportunities and impact value creation in portfolio companies. Drawing attention to ESG risk, one can look at the damage to PE backed Carema's reputation as a consequence of alleged patient mistreatment, and the long term damage to Mengniu Dairy's sales as a result of the 2008 Chinese milk scandal. Looking at the impact of ESG opportunities, KKR's Green Portfolio Programme is one example of many that demonstrates how better management of environmental impacts can improve company performance.

Another dynamic at play is the growing number of LPs requesting that GPs bring consideration of ESG factors into the heart of investment management and that they duly report on their activities to do so. Today, LPs are better able to influence fund terms and increasingly seek commitments on ESG management and reporting from their GPs. While the development of the Principles was convened by the UN, the PRI was created by investors for investors. An investor's main concern, in fact their fiduciary duty, is to look for long term risk-adjusted returns. They are increasingly recognising that ESG factors can be material to the investment process and returns. Improving the understanding of the relationship between ESG factors and value creation is one of the reasons why the PRIs PE working group commissioned this study which explores and provide insights into how large trade buyers are integrating ESG issues into their buying decisions.

The group chose to focus on the mergers and acquisitions (M&A) process because it demonstrates how companies integrate ESG into their own investment processes and gives some insight into how ESG factors may impact returns from PE investments. Trade buyers are an important exit route for PE investments; therefore studying their buying behaviour is key to understanding the materiality of ESG factors.

The findings of this project highlight the growing influence of ESG factors in securing deals and their impact on valuations. It also shows that trade buyers generally believe that GPs are better focused than other sellers on the ESG agenda and have the potential to raise the value of the company through improved performance on ESG factors. All this reinforces the case that effective management of ESG factors can lead to positive risk adjusted returns for PE investors.

Although the survey is not comprehensive, it provides some useful insights into why ESG factors are material and how they can be identified and managed during the due diligence process. While useful knowledge can be gleaned from the findings, they also shed light on key areas where more research and thought is required. The PRI will pursue these in the future.

EXECUTIVE SUMMARY

INTRODUCTION

From June – October 2012 PwC conducted a survey on behalf of PRI, which assessed trade buyers' attitudes to evaluating ESG risks and opportunities in their M&A activities. The survey consisted of 16 interviews with corporate buyers from a range of sectors and involved a discussion around the following key topics: integration of ESG factors into the due diligence process; integration of ESG factors into M&A price, sale and purchase agreements (SPA); and integration of ESG factors in the post-acquisition period.

CONTEXT

- The majority of the companies included in the survey belong to the FTSE 350 and are highly engaged with the sustainability agenda (Appendix A includes a list of selected contributors). For most companies in our sample, the M&A team subcontracts consideration of ESG factors to sustainability specialists in the business. As a result, a high proportion of our interviewees (63%) have 'sustainability roles'.

- The companies involved in the survey are from a variety of sectors and are mainly headquartered in Europe, the US and Canada. However, the vast majority operate globally. Most of these companies have made between one and three acquisitions in the last two years, spread across a wide range of sectors. The locations of acquisitions are also diverse; however, there has been a focus on the US and some BRIC (Brazil, Russia, India and China) countries.

KEY MESSAGES

- **ESG factors can affect the likelihood of the deal occurring.** Two thirds of the interviewees said that poor performance on ESG factors had prevented a deal or affected their willingness to do a deal. On the other hand, good performance on ESG factors can increase motivation to do a deal, with a third of the companies stating that they believed good performance on ESG factors adds to the reputation and brand of the company.

- **Poor performance on ESG factors can have a significant negative impact on the valuation of a deal and can be used as a lever in negotiating the SPA.** Over half of the companies stated that they would expect a discount for poor performance on ESG factors. However, a number of companies also appreciated that good performance on ESG factors is usually integrated in the valuation of the company, although it was mentioned that this is difficult to quantify.

  ESG factors are sometimes used by trade buyers as a lever in the SPA to negotiate downwards on price. The trade buyer may include draft ESG-related indemnities and warranties that the trade buyer knows ultimately cannot be delivered by a GP seller, who is keen to make a "clean" exit. These clauses are sometimes removed at the last minute in return for a reduction in price.

- **The cost and difficulty of bringing a target company up to the trade buyer's standards with regards to managing ESG factors is a significant consideration in the deal process.** A large number of company representatives interviewed mentioned the ease of integrating the acquisition into their company (for example by standardising management controls, policies, procedures and operating systems) as a key factor in their willingness to do a deal. A number of companies stated that if it appears to be too difficult or expensive to integrate the target company and bring them up to their own internal standards on management of ESG factors, their willingness to do the deal would be seriously impacted. A significant proportion of companies consider integration as an opportunity to increase the value and efficiency of the acquired company. In many cases these opportunities are realised through improving areas of poor performance on ESG factors. However, if the standard of ESG management is too low and this opportunity cannot be fully realised then the deal is likely to be impacted.

- **ESG factors are increasingly important in M&A activities.** The majority of companies consider that there has been an increase in the importance of ESG factors in M&A activities and that this trend will continue in the next three years. However, it was evident that the relative importance of ESG issues varies significantly depending on factors such as the sector and location of the deal.

- **Many companies are developing a more systematic approach to ESG due diligence.** Although the majority of companies consider their general approach to sustainability to be quite advanced, a significant proportion recognise that they have a less well developed approach to ESG due diligence. Overall, our survey found a general trend towards the standardisation and formalisation of the ESG due diligence process.

- **Increasingly, trade buyers are integrating ESG factors into their due diligence process but these factors are still not consistently applied to every project.** Although ESG due diligence has not been fully integrated in a large number of the companies, the process has generally become more centralised and co-ordinated by trade buyers. There is, however, variability in the extent to which ESG factors are incorporated into the due diligence process. This is affected by the size and location of the deal and the sector concerned.

PwC's VIEW

ESG DUE DILIGENCE IS EXPECTED TO CONTINUE TO DEVELOP IN SCOPE AND IMPORTANCE

Despite some ESG factors having been a common feature of the due diligence process for about 20 years, notably health, safety and environmental (HSE) issues, our survey shows that the impact of ESG factors in due diligence is still perceived to have increased over the past three years; a trend predicted to continue. It is surprising that only 63% of respondents consistently consider environmental issues in their due diligence, with environmental issues traditionally receiving the most focus in HSE due diligence. PwC would have expected it to have been always considered by a larger percentage of respondents. However, these findings indicate that the approach to ESG due diligence is continually developing and that the focus on these issues is likely to increase as they become more material in the context of transactions.

A key development in ESG due diligence over the past five years has been the emerging realisation that supply chain risks are no longer confined to reputational damage associated with labour standards or environmental performance. Increasingly, companies see operational risks associated with the disruption of natural systems through changing weather patterns and natural disasters (e.g. flood and drought) as a threat to business continuity and want to understand them better.

THE IMPACT OF LOCATION AND SECTOR ON ESG DUE DILIGENCE

Eastern Europe, Ukraine, the Russian Federation, India, China and Turkey all feature as locations of recent acquisition targets in our sample. This reflects emerging market growth and highlights the need to be able to deliver a robust ESG due diligence process under foreign jurisdictions. Regulations in foreign jurisdictions may approach the standards of those in more developed markets but enforcement is often weak or inconsistent.

Differences across sectors can be detected in the responses to the survey. In the extractives and utilities sectors for example, good performance on ESG factors has been part of good business management for at least 20 years. It is integral and understood by all business functions and often applied with insight throughout the due diligence process. Targets generally manage these issues actively and while ESG challenges may exist, they are generally well understood. Both the buyer and seller 'speak the same language' on ESG management and there is usually data to support these discussions. In other sectors, ESG factors have been seen as less business critical in the past and may still be regarded by management functions as peripheral; there is also less of a consensus over what constitutes a material ESG issue. In these circumstances, there is more potential for uncertainty and therefore an even greater need to ensure that ESG factors receive early and systematic consideration in the due diligence process, even if only to be later ruled out as non-material.

THE IMPACT OF ESG FACTORS ON COMPANY VALUATION

ESG issues can theoretically impact the value of a company in a number of ways. This includes not only direct impacts such as cost savings associated with energy efficiency or revenue growth from sales of more sustainable products, but also indirect impacts such as improved risk management, reputation, employee engagement or customer loyalty. However, in practice, few companies currently measure the value that they are generating from management of ESG factors. Moreover, those that do, have yet to consistently communicate how performance on ESG factors creates business value in a way that investors and buyers can understand and build into their valuation models.

As our survey has shown, investors and buyers have little option but to assume that any value impact from ESG factors is already accounted for in the past results of the company and that any future value impact from these factors is already built into the asking price of the company or asset for sale. This may partly explain why the majority of the survey participants said they were unlikely to pay a premium for good performance on ESG factors. Where good performance on ESG factors can be demonstrated however, this may enable a vendor to hold the price and prevent discounts for poor performance.

There is, however, a growing interest in identifying and measuring the specific impact of ESG factors on shareholder value. For example, PwC is working with a number of companies that wish to use ESG valuation to help attract internal or external investment or to inform the prioritisation of future ESG focussed investments. PwC applies standard financial valuation techniques to ESG initiatives, including both tangible and intangible benefits. Moreover, ESG value information is likely to become more widely available in the future as companies experiment with integrated reporting and with ESG valuations.

As a result, the range of ESG issues that are factored into transactions may in future expand beyond pure risk and liability issues such as poor environmental or health and safety performance and begin to encompass eco-efficiency, employee or customer engagement, brand value and the creation of strategic advantage through management of ESG factors.

THE IMPORTANCE OF VENDOR DUE DILIGENCE

Experienced trade buyers know their own sector and know the capacity of their organisations to bring about change in a new acquisition. They tend to take a relaxed view of minor non-compliance issues which can be addressed during the initial phase of new ownership. Significant unknowns, however, or issues with real potential to affect reputation or cause future disruption to operations are viewed more seriously and may be sufficient to cause a buyer to walk away.

The use of significant or unknown ESG factors as levers in price negotiation and in the drafting of SPA's, coupled with the desire for sellers to make a 'clean exit', may be contributory factors in the rise in importance of vendor due diligence (VDD) and the inclusion of ESG factors in its scope. A VDD process enables the seller to set out its performance across a wide proportion of the business and gives the seller more control of the due diligence process.

Good quality disclosure which shows that the ESG factors have been carefully considered throughout the period of ownership, can potentially remove a price reduction 'lever' from a trade buyer during negotiations. Little or poor quality information on performance on ESG factors may create doubt over the quality of management of ESG factors. The precise scope of ESG information placed in the data room will, of course, depend on what is available, but examples include:

- ESG policies;
- any external reports on the ESG status of individual portfolio companies, and of the portfolio as a whole;
- copies of any management system standard certificates (ISO 14001, OHSAS 18001 etc);
- copies of any regulatory licences/consents, and details of any breaches;
- details of performance on ESG factors, using Key Performance Indicators (KPI) where appropriate;
- details of health and safety accidents/incidents; and
- any evidence of governance arrangements (such as Codes of Conduct, Bribery and Corruption Policies, or whistle blowing hotlines).

INTRODUCTION

ABOUT THE SURVEY

There are three key routes for PE funds wishing to sell their interests in a company: an initial public offering (IPO); a sale to a trade buyer; or a secondary sale to another financial buyer e.g. a PE firm (hereafter referred to as General Partner or GP). In 2011, trade buyers accounted for 63 per cent of European PE exits by value, up from 27 per cent in 2010[1], and in the current climate where corporate trade buyers are relatively strong in the M&A market they are seen as an important exit route for investors. The survey aimed to identify trade buyers' current attitudes to evaluating ESG risks and opportunities in their M&A activities. We hope this will:

- help companies and GPs understand whether and how trade buyers consider these issues and what impact they may have on the sale process;
- provide insight for GP sellers into how best to prepare for ESG related questions during a trade sale process; and
- illustrate to LPs the benefit of seeking information from GPs on their approach to ESG issues.

The survey consisted of 16 in depth interviews aimed at obtaining meaningful responses from trade buyers operating in a range of sectors. The interviews involved a general discussion on the company's approach to sustainability, a brief overview of M&A activities in the past few years and some more detailed questions based around consideration of:

- ESG factors in the due diligence process;
- ESG factors in M&A price and SPA; and
- ESG factors in the post-acquisition period.

Participants were placed into one of four categories (basic, intermediate, strategic, and leadership) which related to their approach in each of the key topic areas. More information on these categories and the approach to the survey can be found in Appendix B.

WHAT ARE ESG FACTORS?

All interviewees were informed of the factors that were considered to be included in the definition of "ESG factors".

ESG factors are environmental, social and governance risks and opportunities facing businesses. PwC considers ESG factors to include:

- **Environmental issues** which encompass pollution and contamination of land, air and water; related legal compliance issues; eco-efficiency ("doing more with less resources"); waste management and recycling and reuse; water use and efficiency; energy use and efficiency; natural resource scarcity; climate change and carbon emissions reduction strategies; and hazardous chemicals.
- **Social issues** which encompass the treatment of employees; health & safety; labour conditions; child labour; human rights; supply chains; equality and diversity; and treating customers and communities fairly.
- **Governance issues** which encompass the governance of environmental and social issue management plus the areas of anti-bribery and corruption, business ethics and transparency.

The definition for governance used in the survey does not include some issues which may typically be included in governance, such as accounting standards, executive remuneration and political contributions. This is because these factors will generally be covered by the financial due diligence process.

STRUCTURE OF SURVEY FINDINGS

The survey findings are organized around four key areas.

1. Integration of ESG factors into due diligence

Interviewees were asked for details of acquisitions in the last two years and their approach to the due diligence process with respect to ESG factors. This included resources for ESG due diligence; the ESG factors, scope and data that are considered in the due diligence process; assessment against local legal compliance with respect to ESG factors; and the consideration of future costs of compliance.

2. Integration of ESG factors into M&A price and SPAs

We assessed the effect of ESG factors on trade buyers' willingness to do a deal and valuation of deals, including whether the actions of GPs affect the value of companies. We also looked at the inclusion of ESG factors in SPAs.

3. Integration of ESG factors in the post-acquisition period

Interviewees were surveyed on the inclusion of ESG factors in post- acquisition work plans, including requirements for progress updates on the management of ESG factors and consideration of potential opportunities related to ESG factors.

4. Internal sustainability strategy and policy

We questioned companies on their overall approach to sustainability, including what consideration they have given to their material ESG factors and governance of ESG factors.

1. CMBOR/Equistone/ E&Y (2011) UK buyout data.

SURVEY FINDINGS

1. INTEGRATION OF ESG FACTORS INTO DUE DILIGENCE

ESG FACTORS, SCOPE AND DATA CONSIDERED IN ESG DUE DILIGENCE

Most of the companies mentioned that they often screen for ESG factors in order to identify:

- reputational risks;
- areas for discounting price;
- opportunities to increase value after acquisition; and
- ensuring that the costs of post-acquisition integration of target companies are not excessive.

The relative importance of ESG factors varies depending on the sector of operation and this determines which issues companies consider to be of the highest risk to their business. 63% of companies said that they always consider environmental issues in their due diligence, 44% always consider social issues and 38% consider governance issues in every deal, as shown in figure 1 below. Although social and governance issues generally receive less focus in relation to ESG due diligence, a number of companies stated that these issues are growing in importance, particularly in relation to acquisitions in emerging markets. This may also be explained by the inclusion of social and governance issues, such as bribery and corruption, in the main financial due diligence process.

What ESG issues do you generally consider in due diligence?

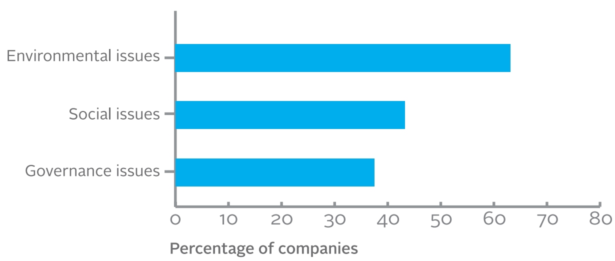


Figure 1: ESG factors considered by the companies during due diligence

Three companies stated that the ESG factors considered as part of the due diligence process are dependent on the specific nature of the deal e.g. sector, location, size etc. A large number of companies mentioned that they are often looking for areas of poor performance on ESG factors and the costs of integration as well as risks to the trade buyer's reputation.

"We consider environment and social issues to be the most important, particularly pollution and child labour. However, governance is also important, particularly bribery and corruption which are rising in importance."

Over half of the organisations said that they did not give a higher weighting to any of the ESG factors they considered in due diligence relative to others. Of the remaining half, 19% of the companies gave a higher weighting to health and safety issues, 19% to environmental concerns, 13% to social issues and 6% to governance issues. Those companies that attached a higher weighting to specific ESG factors were influenced by the issues they considered to be of the highest risk to their business. For example, one company mentioned a project in which local community issues had prevented them from obtaining the required licences.

"H&S and environment issues are included and sometimes we include social and governance. Because we are buying companies in emerging markets, social and governance issues are becoming more important in due diligence."

In addition to the 'traditional' focus on target operations, 43% of the companies said that they also look at the whole value chain; considering impacts potentially associated with the supply chain and also perhaps, those associated with distribution and sales and marketing.

"We look across the entire value chain as risks here could affect the business."

"There is a critical dependence on materials and sources of supply which means we need to consider the supply chain in our due diligence process. In the future we will also consider Scope 3 carbon emissions and CSR strategy in the supply chain."

Half of the companies report that they expect to be able to obtain some performance data for ESG related KPIs.

This is mainly focused on health and safety data, as well as environmental performance data to identify risks and baselines for ESG related KPIs. Data on water quality, water consumption, energy and waste are also considered to be important. In addition to identifying risks related to KPIs, companies are also looking to identify opportunities:

"One of the key issues that we look at is how the acquisition can be run better, more efficiently, and cheaper. This automatically means that it makes sense to look at energy, waste and water consumption."

ACQUISITIVE BEHAVIOUR OF COMPANIES

There was a wide variation in the number of acquisitions that the companies had made over the last two years (See figure 2 & 3 below). The majority of companies have made between one and three acquisitions over the last two years which have been spread across a wide range of sectors.

The locations of acquisitions are also diverse; however there has been a focus on the US and some BRIC (Brazil, Russia, India and China) countries, see figure 3 below.

How many acquisitions have you made in the last two years?

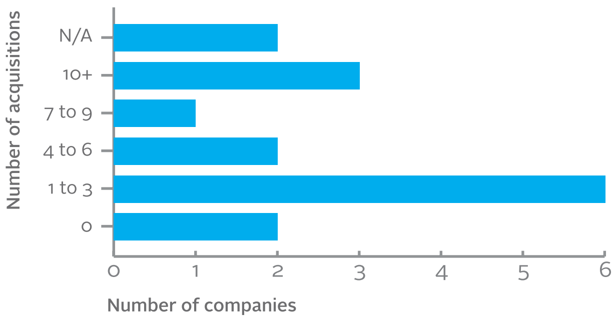


Figure 2: Number of acquisitions by participating companies in the last two years

INTERVIEWEES' APPROACH TO THE DUE DILIGENCE PROCESS WITH RESPECT TO ESG FACTORS

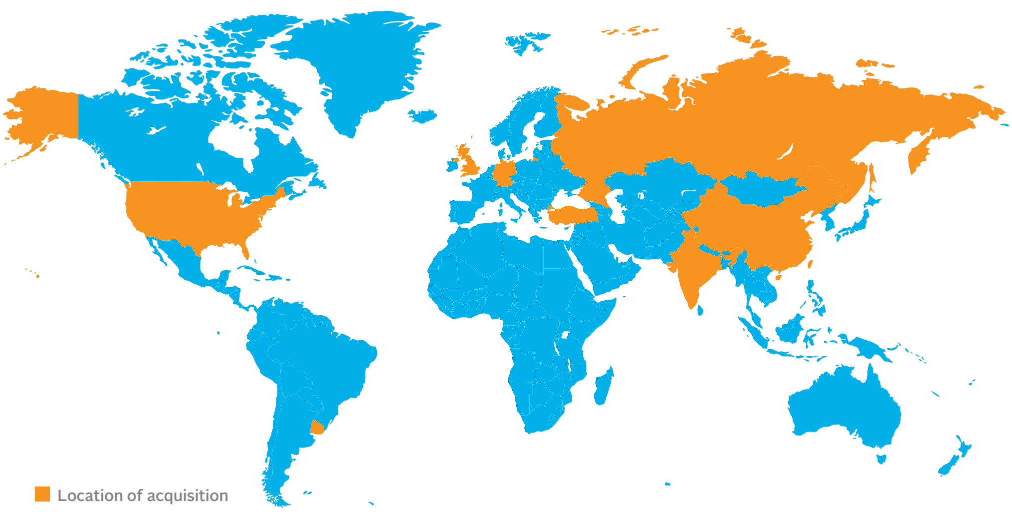
Although ESG factors have not been fully integrated into the due diligence process in a number of companies, ESG due dilgence has generally become more centralised and co-ordinated at a group level. The majority of companies (63%) have a 'strategic' approach to ESG factors in the due diligence process which illustrates that they have a clearly defined ESG due diligence approach and have incorporated it into the main due diligence process (Figure 4). Companies with a 'strategic' approach tended to have consistent standards which they apply across all deals.

"The integration of ESG factors in due diligence used to be quite sporadic but is now a part of the due diligence process. ESG factors do have to be integrated and people are aware of this. There are strong links between the Finance and CSR Committees."

Although the majority of companies have a well advanced approach to general sustainability at the overall corporate level, a significant proportion have a less well developed approach to ESG due diligence, with 31% of companies having a 'basic' or 'intermediate' approach. This signifies that they use flexible processes that can change on a case by case basis depending on sector, region, the target company's product or services or deal size.

"We don't have an ESG checklist as we look at each target on a case by case basis and in direct engagement with relevant stakeholders."

LOCATION



SECTORS

Energy
- Nuclear
- Renewable Energy

Retail
- Outdoors Gear
- Diamonds
- Flour

Minerals

Manufacturing
- Automotives

Packaging

Plantations

Figure 3: Location and Sector of recent acquisitions made by trade buyers interviewed

'It depends on the size of the acquisition and the risks involved; the DD is relatively limited for smaller assets'.

How do you approach the due diligence process with respect to ESG issues?

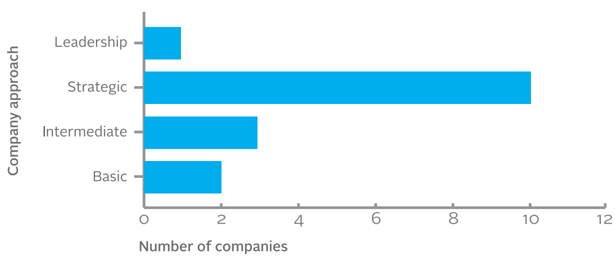


Figure 4: Companies' approach to the due diligence process with respect to ESG factors

Only one company classified themselves as a leader in this field, stating they had fully embedded the ESG assessment into the due diligence process. However, several companies commented on the benefits of incorporating ESG factors into the core due diligence process e.g. by reducing the workload for the deal team.

"People want just one set of questions, so we try to include everything together and send a draft around the team to see if anything else needs to be included in the one set of questions."

THE IMPACT OF THIRD PARTY ASSURANCE

50% of companies commented that some form of third party assurance certification over ESG activities positively affects their appetite to do a deal.

The main reason for this is related to the ease of integration i.e. a third party certification may imply that there is a certain level of management over ESG factors which would likely make it easier to bring the target up to the trade buyers' internal standards. If the target has the same certifications as the trade buyer then this was seen as an additional bonus.

However, the majority of companies said that third party assurance has not replaced their own due diligence process and it is unlikely that it will impact the due diligence process in the future as it only has a limited impact on the thoroughness with which they evaluate a potential acquisition.

RESOURCES FOR ESG DUE DILIGENCE

75% of the companies interviewed use a mixture of in-house and external experts for the ESG due diligence process, as shown in figure 5 below.

Where do you obtain resources for your ESG due diligence process?

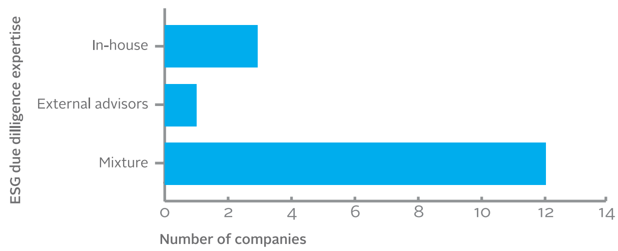


Figure 5: Resources for ESG due diligence

Many of the companies commented that the use of external advisors was dependent on the sector and/or size of the deal. The source of the internal specialists varied including M&A, CSR, HSE teams, plus in one case a renewables team, and an environment and technical specialist group. One company surveyed integrated the management of ESG factors into all of its operations and has a separate specialised team for advice.

Most companies interviewed tended to use external experts where they did not have the knowledge or expertise to do this in house or where the location or sector of the deal was not familiar. This was not necessarily reflective of the significance placed on ESG factors.

"Depends on the business, for example insurance or tidal energy companies require external experts as we don't have internal knowledge of these industries."

"[Our company] uses internal and external ESG experts working as part of the core deal team, depending on the scale. External experts are used particularly in countries which [our company] has no expertise in."

CONSIDERATION OF COMPLIANCE WITH LEGAL REQUIREMENTS AND RISKS & OPPORTUNITIES

69% of companies assess potential acquisitions for compliance against local legal requirements but will proceed if there are minor non-compliance issues which can be addressed post-acquisition.

"If local compliance is not reached we will go in and bring the company up to standard."

A large proportion of the interviewees stated that they would refuse a target if there are serious implications related to non-compliance and poor performance on ESG factors i.e. if the potential acquisition could not be brought up to the required standards or the cost or reputational risk was too high. An example of a deal being prevented by ESG factors is the inability to obtain operational licences in South East Asia due to projects located in areas where there are protected species.

"A potential target was abandoned because they proposed to dredge a pristine river as part of the project."

Over two thirds have a 'strategic' or 'leadership' approach to the due diligence process, with company policies and procedures for ESG factors and a consideration of material ESG impacts on capital expenditure (CAPEX) and operational expenditure (OPEX). These companies will be looking for compliance against all local legal requirements as a minimum and for acquisitions that are already operating at a similar standard to themselves. Some companies stated that ideally they would like acquisitions to be operating at an international standard.

The 25% of companies with a 'leadership' approach also consider the importance of looking for ESG risks and opportunities, particularly cost savings from efficiency improvements and increasing the value of the acquisition by improving its performance on ESG factors:

"A recent acquisition of [ours] created an opportunity as its business aligned very well with [ours], and cost savings could be achieved through the merger of some of the services."

"Opportunities for increasing efficiency in acquisitions can lead to financial savings of £10m per annum and 10-20% increase in efficiency in the first few years after acquisition."

"We investigate compliance but we also look at positive and negative aspects of ESG performance which could be enhanced to add value or which need to be improved to ensure that trust in the brand continues."

THE FUTURE COST OF COMPLIANCE WITH REGARDS TO ESG FACTORS

Approximately one third of companies consider the cost of compliance for ESG factors for up to two years and a quarter for up to five years post- deal, as shown in figure 6 below. Another quarter considers the long-term costs of compliance for ESG factors, including two companies which look at the costs for the lifetime of the assets.

The materiality threshold for ESG factors is, in most cases, dependant on the size of the deal; however a large proportion of interviewees stated that this was likely to be in the hundreds of thousands or millions of pounds. It was difficult for some of the companies to provide an exact figure because the costs were assessed as part of the overall CAPEX and OPEX.

Over what time period do you consider the future costs of compliance with regards to ESG issues?

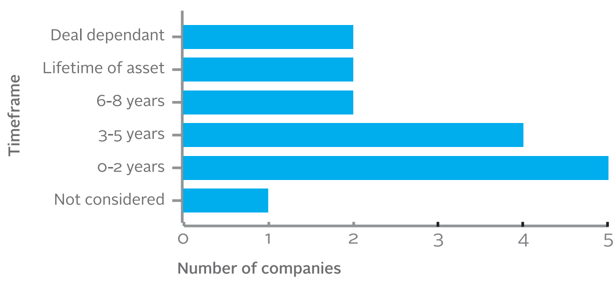


Figure 6: Timeframe for the future costs of compliance with ESG factors

"ESG related costs are embedded into overall CAPEX/ OPEX, they are not considered separate as ESG factors are considered part of core operations."

A number of companies which do not currently integrate the potential cost of liabilities relating to ESG factors into the overall costs, plan to incorporate this in the future.

"In future acquisitions there will be ESG CAPEX requirements and it will be treated like any other future business cost i.e. incorporated into the discounted cash flow. For some of our acquisitions this was considered e.g. CAPEX for efficiency improvements to buildings."

THE INFLUENCE OF ESG FACTORS ON TRANSACTIONS

The majority of companies, 63%, think that there has been a large increase in the influence of ESG factors in transactions in the last three years, and 75% perceive that there will be a large increase over the next three years (Figure 7).

The influence of ESG factors in M&A

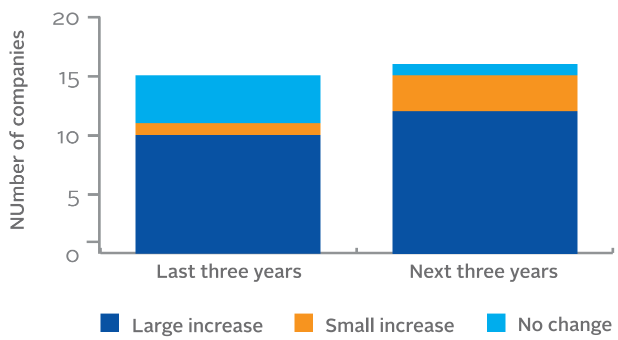


Figure 7: The change in the influence of ESG factors on M&A activities

"The awareness of climate change among senior management and the board in companies is ever increasing and thus the influence of ESG factors will increase."

It is the opinion of most of the companies surveyed that the increasing influence of ESG factors is an ongoing trend, with many citing reasons such as increased prices for natural resources, increasing expectations and demands from customers and global events, such as global warming. However, the level of influence of ESG factors is sector dependent, for example relating to resource requirements, regulation and social pressures.

"The increase in the influence of ESG factors is based on megatrends rather than small fluctuations e.g. Rio+20 Earth Summit and the Fukishima Daiichi nuclear disaster."

"[Our] CEO considers that ESG factors will only become more important for the industry. ESG factors are an extremely important aspect of executing [our] strategy – good assets are scarce, the remaining assets are exploited or in remote or politically sensitive areas."

2. INTEGRATION OF ESG FACTORS INTO M&A PRICE AND SPAs

THE IMPACT OF POOR OR POSITIVE PERFORMANCE ON ESG FACTORS ON THE LIKELIHOOD AND VALUATION OF A DEAL

ESG factors can have a significant impact on M&A activities as demonstrated by the fact that over 80% of companies have reduced the valuation of an acquisition target or not gone ahead with a deal because of poor performance on ESG factors. 56% of companies have experience of both (figure 8). 75% of companies stated that poor performance on ESG factors had prevented a deal. This is related to a number of issues including: contaminated land; poor trade union relationships; child labour and community relations; and the risk of natural disasters. A large number of the companies interviewed mentioned ESG factors as key in their appetite to do a deal. A number of companies stated that their willingness to do the deal would be seriously impacted if the potential risks and costs are unclear, and if it appears to be too difficult or expensive to bring the target company up to their own internal standards on ESG factors.

Has poor ESG performance in a target company influenced your willingness to do the deal? Valuation of the deal? Or both?

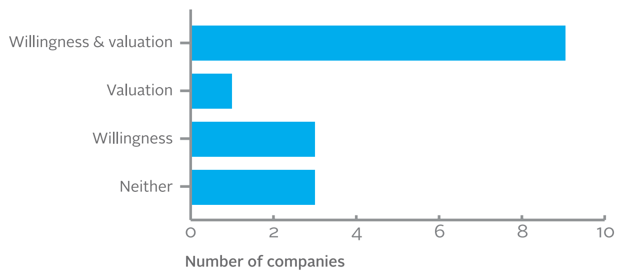


Figure 8: The effects of performance on ESG factors on companies' willingness and valuation of deals

"One company we looked at was a yeast plant which had issues around effluent discharge. However, there was too much required to bring the company up to our own internal standards and therefore we pulled out of the deal."

"To give one extreme example: [we] were paid to acquire one factory as part of the deal because the HSE-related costs were so high that the seller wanted to get rid of the asset."

A significant proportion of companies stated that they would look at areas of poor performance on ESG factors as an opportunity to increase the value of the company during post-acquisition integration.

PAYING A 'VALUATION PREMIUM' FOR COMPANIES CLEARLY DEMONSTRATING STRONG ESG PERFORMANCE

Overwhelmingly companies expect a discount for poor performance on ESG factors but are not willing to pay a premium for good performance on ESG factors. However, a number of companies appreciated that good performance on ESG factors is usually integrated in the valuation of the company e.g. a highly satisfied workforce will lead to a more stable and productive company. It is generally accepted that the starting price assumes that the target company has good performance on ESG factors so that the acquiring company will look to receive a discount for any negative issues that emerge.

"A valuation discount is based on the need for investment in the future and any liabilities. We take a starting point which assumes the company has good performance and then [we] work the price down by about 5-10%. If it's over 10% we would seriously consider if it is worth doing the deal."

Good performance on ESG factors can increase motivation to do a deal and a third of the companies surveyed believed that good performance on ESG factors adds to the reputation and brand of the company. In addition, a number of companies highlighted the non-monetary benefits of good performance on ESG factors, such as increasing the speed of the acquisition process.

"[We] don't pay a premium but it would be a motivation to do the deal. It could sway [us] towards a particular deal if there were several deals on the table"

THE EFFECT OF GP OWNERSHIP ON VALUATION

70% of companies that have been involved in a transaction with a GP perceive that it has impacted the value.

Generally, it is believed that GPs are better focused on the ESG agenda than other sellers and raise the value of the company through improved performance on ESG factors.

"PE Houses used to have a bad reputation, but this is not really the case anymore. Nowadays, it depends on which PE house is concerned. Actions of PE houses do have the potential to significantly affect the valuation of a portfolio company. However, the same could be said about other actions such as board decisions."

"PE houses manage ESG factors and this would be taken into consideration i.e. they would look at the owner themselves and look at their historical performance in the management of ESG factors."

The majority of companies also commented on the issue of liability, stating that this may impact the value or put them off the deal.

"[The company] knows that they can't get recompense from PE houses so they know that they need to get the right price as they can't go back and sue them."

"It makes a difference if the PE house is the owner as they are more educated and informed and better able to understand value. However, with a PE house there can be no indemnities or warranties. This sharpens the process; the company has to sort out any issues at the time of acquisition."

It should be noted that a significant number of the companies interviewed, 31%, have never conducted a deal with a GP and were therefore unable to comment.

THE INCLUSION OF ESG FACTORS IN A SPA

Over 80% of companies have included ESG factors in a SPA. This is generally related to environmental liability and in particular contaminated land, but can also include health and safety and social issues.

"Phase I/II reports are often included in SPAs as annexes. They can be very detailed due to the nature of the subject matter (i.e. unknown to legal/financial teams). The devil is in the detail especially considering the potential for multimillion dollar cost implications further down the line – therefore the high level of detail is important."

ESG factors can be used by trade buyers as a lever (in the SPA)to negotiate on price, with the inclusion of ESG related indemnities and warranties. Trade buyers know that ESG related indemnities and warranties are unlikely to be accepted by the seller. In particular, this was noted as an issue with respect to GPs because they are unlikely to accept ongoing liability.

"We try to put all ESG factors into the SPA (even if the PE house cannot accept it) as a price negotiation tactic. [We] put everything on the table in the first instance - the PE house will not accept the liability and either we ask for more information to get comfortable or [we] will ask to reduce the price."

3. INTEGRATION OF ESG FACTORS IN THE POST-ACQUISITION PERIOD

INCLUSION OF ESG FACTORS INTO POST-ACQUISITION WORK PLANS

Three quarters of the companies surveyed have either a 'strategic' or 'leadership' approach to including ESG factors in their post-acquisition work plans, which signifies that they have detailed work plans relating to ESG factors with key actions outlined. The more advanced companies set targets and require reporting of performance against these targets to bring performance on ESG factors in line with their own standards.

Most of the companies want action plans to be in place from day one following acquisition. In most cases the time frame is dependent on the type of issues and the size of the asset, and legal requirements take precedence.

"ESG factors are included in post-acquisition work plans. As they are included in the due diligence process, specific issues have been mapped during that process and timeframes have been worked out. Past experience shows that the plan would be quite detailed."

A third of the companies reported that it would be easier to integrate a company if it already complied with their own ESG standards. However, over half reported that they would not expect them to comply with their own internal standards but would expect to have to improve performance following acquisition.

PROGRESS UPDATES ON MANAGEMENT OF ESG FACTORS

Three quarters of companies require progress updates on management of the ESG factors including updates on any areas of poor performance that were identified in the due diligence process. The frequency of this varies from quarterly to every 18 months. Over half of the organizations surveyed expect companies to report on ESG developments within 6 – 18 months of acquisition.

"[We] conduct an audit to set a baseline and appropriate targets. [We] require quarterly updates on energy, water, waste and social commitments."

ESG OPPORTUNITIES IN THE POST-ACQUISITION PERIOD

90% of companies who include ESG in post-acquisition work plans consider ESG opportunities in the post-acquisition period. The focus varies, with some companies looking to improve performance on ESG factors to create value, for example by improving employee absence or reducing environmental impact.

"We look for areas to make improvements in ESG performance that can drive overall improvements e.g. decreasing employee absence."

Several companies use ESG factors as a way to build relationships with the new company and others concentrate on how they can use the skills of the acquired workforce across the entire group and learn about other opportunities.

4. INTERNAL SUSTAINABILITY STRATEGY AND POLICY

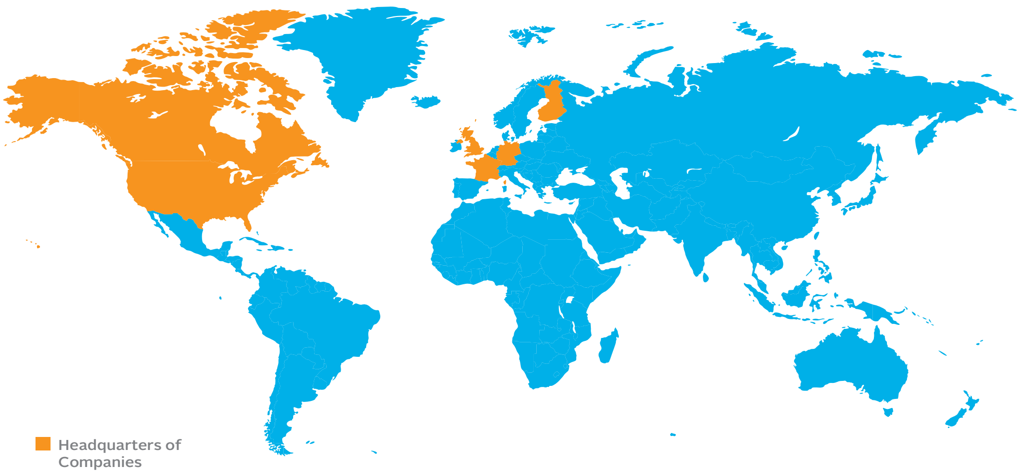
CHARACTERISTICS OF SURVEY RESPONDENTS

The majority (over 75%) of the companies included in the survey belong to the FTSE 350 and are highly involved with the sustainability agenda. The majority of companies have well developed overarching sustainability strategies; have a good understanding of ESG risks and opportunities for their business; and report on ESG factors to the CEO, the Board or a Board level committee.

Our choice of interviewees was informed by the fact that for most companies the M&A team subcontracts consideration of ESG factors to sustainability specialists in the business; this resulted in a high proportion of our interviewees (63%) having 'sustainability roles' (although in some cases they had previously had wider business and management responsibilities). The remainder of the interviewees consisted of 31% from finance and M&A roles, and one person in a legal position.

The companies were interviewed from a number of sectors, as shown in figure 9 below. Most of the companies are headquartered in Europe and the majority in the UK, with two headquartered in Canada and the US. However, despite being mainly head-quartered in Europe, the vast majority of the companies operate globally; with operations spanning at least four or five regions.

LOCATION



REGIONS OF OPERATIONS

- Europe
- Asia
- North America
- Africa
- Australasia
- South America

SECTORS

Energy

- Utilities & energy services

Media

- Marketing
- Deal execution platforms & investor communications

Manufacturing

- Pulp and paper
- Automotives

Pharmaceuticals

Plantations

Chemicals

Food & Ingredients

Mining

Metals

Construction

Packaging

Real Estate Investment

Strategic Outsourcing

Engineering & Project Managing

Figure 9: Sector, location of headquarters and regions of operation of surveyed companies

Analysing the results by sector shows that in general the food and manufacturing sectors have well developed approaches in all areas of the acquisition process with respect to ESG. However, construction, pharmaceuticals and media sectors have a ‘basic’ or ‘intermediate’ approach with respect to ESG factors in the due diligence process but have a ‘leadership’ approach in relation to the inclusion of ESG factors in post-acquisition work plans. Energy & Mining companies mainly had a ‘strategic’ approach in sustainability but varied between ‘intermediate’ and ‘leadership’ approaches to ESG factors before and post-acquisition (see Figure 10 below).

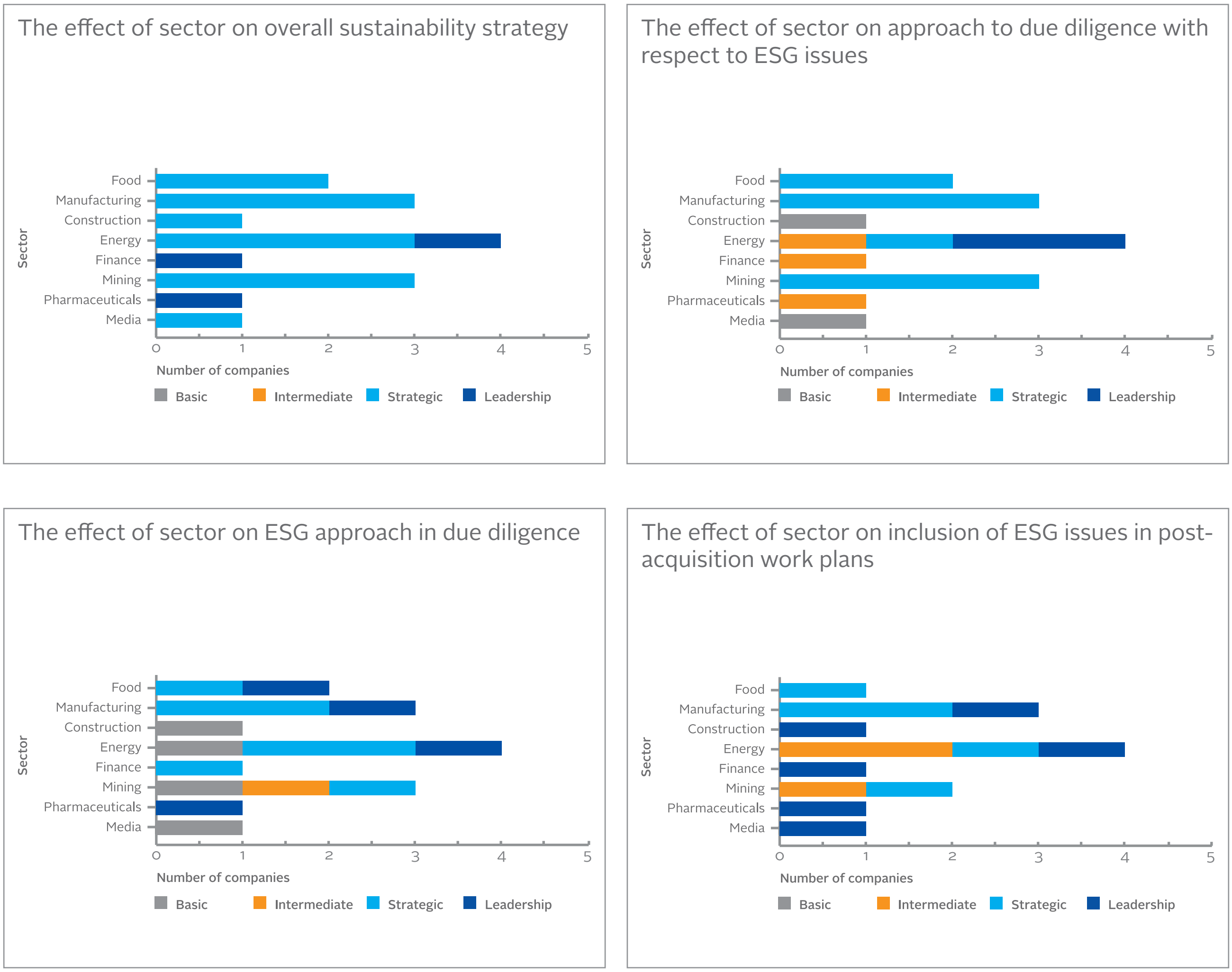


Figure 10: The effect of sector on approach to overall sustainability strategy and ESG factors during and post-acquisition

OVERALL APPROACH TO SUSTAINABILITY

All of the companies interviewed have either a 'strategic' or 'leadership' approach to sustainability, which signifies that they are at a minimum thinking about key ESG risks and opportunities that are relevant to their business and are starting to take a long-term 'strategic' view on what will drive their business in the future. Over a third said that they were striving for 'leadership', or were leaders, in sustainability, which signifies that senior management are highly engaged and are driving forward the company to address ESG risks and capitalise on opportunities as well as engaging with relevant stakeholders. Many of the companies noted that sustainability is growing in importance for their businesses. They also noted that the historic attitude to ESG factors as a compliance matter has been replaced with the realisation that a consideration of ESG factors is not only a necessary part of business but also an opportunity to increase their competitive edge.

Our survey showed that this change has been driven in part by increasing involvement from board and senior management and increasing demands from customers - being able to manage ESG factors effectively is seen as being important for the company's brand.

"[We] used to mostly comply with necessary ESG regulations, then moved towards operational efficiency, but have moved to thinking more strategically about ESG factors."

"Aiming to be a leader in sustainable development is a business imperative and is being considered strategically."

CONSIDERATION OF MATERIAL ESG FACTORS

Almost all the companies interviewed have given some consideration to their material ESG factors. 81% of those who have identified their material ESG factors stated that they are currently focusing on environmental risks and opportunities. This is because they considered these issues to be more material to their business, in particular: greenhouse gas emissions, energy use, water use, supply chain management, waste management, use of renewable materials and minimising deforestation.

Half of those who have identified their material ESG factors also specified that they are focusing on social issues e.g. looking at the relationship with local communities and ensuring the wellbeing of their employees.

Half of the companies interviewed include material ESG risks in either their corporate risk register or annual report. These companies report that they are taking ESG risks seriously and are considering these risks in their overall corporate strategy.

"ESG factors are included in the corporate risk register – 3 of the top 10 risks are related to ESG."

81% of participants thought that environmental issues were material to their business.

ABOUT THE WORK STREAM

Established in 2007, the PE work stream is one of the PRI Initiative's most active. It brings together investors and the wider PE industry to explore responsible investment issues and interactions between LPs, GPs and portfolio companies.

WORKSTREAM MANAGER

Fong Yee Chan

T: +44(0)2077495162
E: Fongyee.chan@unpri.org

CONTACT PRI

2 Bath Place, Rivington Street
London, UK EC2A 3DR

T: +44 (0) 20 7749 1940
E: info@unpri.org
www.unpri.org

PwC KEY CONTACTS

For further information please contact:

Phil Case
Director PwC

T: +44 (0)20 7212 4166
E: philip.v.case@uk.pwc.com

Geoff Lane
Partner PwC

T: +44(0)207 213 4378
E: geoff.lane@uk.pwc.com

PREPARATION OF THIS DOCUMENT

This document was prepared by PwC with support from the PRI PE working group and the PRI Secretariat. The recommendations and suggestions it contains are those of PwC, the representatives of the Working Group, and the PRI Secretariat. They should not be interpreted as representing the views of individual PRI signatories or the PRI initiative as a whole. The PRI Secretariat would like to thank all working group members for the significant contributions to this document.

Tom Rotherham - PE Exits research working group chair
Hermes EOS

Maaike van der Schoot - PE steering committee chair
AlpInvest Partners

Haran Narulla
Blue Wolf Capital Partners

Joy Williams
Ontario Teachers' Pension Plan

Melissa Brown
Daobridge Capital Limited

Ritu Kumar
Actis

Rina Kupferschmid-Rojas
ESG Analytics

Tanya Carmichael
Ontario Teachers' Pension Plan

Edited by **by Fong Yee Chan, Katie Beith** and **Rob Lake.**

APPENDIX A: SELECTED CONTRIBUTORS

Aegis Group plc
Alliance Boots plc
Anglo American plc
Centerra Gold Inc
Centrica plc
EDF S.A.
E.ON SE (formerly E.ON AG)
Interserve plc
MITIE Group PLC
Rexam PLC
Stora Enso Plc
Tate & Lyle PLC
The British Land Company plc
Xstrata plc

APPENDIX B: APPROACH TO THE SURVEY

The survey consisted of 16 in depth interviews aimed at obtaining meaningful responses from trade buyers operating in a range of sectors. It was determined that this approach was more likely to provide quality information than a more quantitative questionnaire issued to a larger number of participants. However, it should be noted that the nature of the survey meant that the interviewees could be seen as being self-selecting i.e. companies that are not active in M&A or who do not actually consider ESG factors in M&A were less likely to agree to participate in the survey than those companies who are active. The interviews involved a general discussion on the company's approach to sustainability, a brief overview of M&A activity in the past few years and some more detailed questions based around consideration of:

- ESG factors into the due diligence process;
- ESG factors in M&A price, SPAs; and
- ESG factors into the post-acquisition period.

The data collected were analysed in order to identify trends in trade buyers' attitudes to evaluating ESG risks and opportunities in their M&A activities. In addition, the responses were reviewed for differing opinions or approaches.

INTERVIEW PROTOCOL

The participants were placed into one of four categories which relate to their approach in each of the topic areas, as described above. The four categories developed by PwC are:

- **Basic:** the company is only focused on meeting legal requirements and/or no consideration of ESG factors during due diligence. ESG factors are not considered in the due diligence process.
- **Intermediate:** the company believes there is a business case for addressing and managing ESG risks as well as wider environmental and/or social benefits. There is a clearly defined ESG due diligence process which is separate to the core due diligence process. The company has some policies and procedures for analysing ESG factors in the due diligence process. The company has a high level overview/plan related to managing ESG factors post- acquisition.
- **Strategic:** the company is thinking strategically around key ESG factors and starting to take a long term strategic view around what will drive the business in the future. The company considers any material impacts on CAPEX and OPEX in due diligence. Core process includes clearly defined ESG due diligence. The company has detailed plans with key actions outlined for target companies post-acquisition
- **Leadership:** Senior management are highly involved with the ESG agenda and driving the company forward to take innovative and leading actions addressing risks, capitalising on opportunities, engaging with relevant stakeholders and good reporting. Risks, costs and opportunities are considered in the due diligence process and a full ESG assessment is embedded into it. There is a detailed work plan for target companies post-acquisition with targets and reporting of performance against these targets.

This page has been left blank intentionally

This page has been left blank intentionally

This page has been left blank intentionally

OUR UN PARTNERS

United Nations Environment Programme Finance Initiative (UNEP FI)
UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UN Global Compact
Launched in 2000, the United Nations Global Compact is a both a policy platform and a practical framework for companies that are committed to sustainability and responsible business practices. As a multi-stakeholder leadership initiative, it seeks to align business operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to catalyse actions in support of broader UN goals. With 7,000 corporate signatories in 135 countries, it is the world's largest voluntary corporate sustainability initiative.

More information: www.unglobalcompact.org

UNEP Finance Initiative
Innovative financing for sustainability

United Nations Global Compact